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Analysis of Stock Screening Principles in Islamic Mutual Funds

Industry

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Abstract

According to Islamic principles for investments in stocks, *market price per share* should be greater than *net liquid assets per share*. It may suggest that this principle restricts investments in the stock of liquid companies. Creditors prefer a favorable Current and Quick ratio but shareholders are not exactly happy when the company has immense liquidity. Excess liquidity implies the company has excess funds, but it has not invested them in its operations fully. There is a trade-off between profitability and liquidity companies have to make. Cash equivalents and marketable securities usually yield a return that is negative in real terms in most developing countries.

The interests of creditors are managed by another principle that if a company has financed a portion of its assets with interest bearing debt; then, the interest bearing debt should not be more than 40%. Debt financing is a double-edge sword. Leveraged companies can magnify their returns in booms, but in slumps, they lose the edge and can even go bankrupt and make both their shareholders and creditors suffer. Debt financing results in a zero-sum game in which at least one stakeholder i.e. shareholders or creditors suffer. Equity financing ensures normal returns in booms and survival in slumps. Therefore, the company will not be squeezed of liquidity as interest expense as an 'autonomous expense' will not feature as a significant portion of total operating expenses.

But, how to become shariah compliant is a logical question to ask at this point. There are certain principles that need to be followed to become shariah compliant. This paper will discuss how a company can become a shariah compliant KMI-30 company by using economic models and established deductive knowledge in Economic, Finance and Portfolio theory.

Background of the Study

Islamic economic principles require enterprise and/or labor in the pursuit of livelihood. The means of livelihood that do not include enterprise and/or labor are not allowed in Islamic principles such as interest based money lending, gambling etc. Islamic principles also require economic pursuits to be of highest ethical order. It does not permit the business of prostitution, casinos, alcohol, drugs etc. Islamic principles permit economic pursuits subject to ethical and shariah compliance. Islamic principles do not permit unbridled pursuit of self-interest that results in a zero sum game in which the gain of one is always at the expense of the other. Hence, transactions involving ‘Gharar’ and ‘Zarar’ are also not allowed.

The most distinguishing feature of the Islamic economic system is the prohibition of interest. Usury, Interest and Riba are synonymous terms but they have different technical meanings. Usury refers to the consumption loans given on higher rates and thus causing exploitation of the borrower. Interest refers to the cost of using money in finance and economic theory.

Interest is prohibited in all monotheist religions (See Exodus 22:25, Leviticus 25:35-36, Deuteronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12).

Islamic economic principles have prominently been applied in financial industry especially in banking. In Egypt, first Islamic savings bank was established based on the principle of profit-sharing at Mit Ghamr in 1963. The Islamic financial system in

Malaysia was introduced in 1963. Bank Islam Malaysia Berhad (BIMB) commenced business on 1 July 1983.

In 1975, the Islamic Development Bank was established to provide financing to projects in the member countries. Dubai Islamic Bank was the first modern Islamic commercial bank founded in 1975. Indonesia's first Islamic bank was Bank Muamalat, which was established in 1991. In Bahrain, first Islamic commercial bank was established in 1978.

In Pakistan, Meezan Bank was the first Islamic commercial bank established in 2002. The branch network of 6 full-fledged Islamic banks and 12 conventional banks (with dedicated Islamic banking branches) increased to 528 branches by June 2009. It is estimated that Islamic banking will achieve a market share of 12% by 2012 in Pakistan. (Source: SBP Strategic Plan for Islamic Banking 2009).

Total assets of Islamic banking in Pakistan reached Rs. 313 billion by June 2009. The financing and investment portfolio of Islamic banks reached Rs. 195.0 billion by June 2009. In terms of market share, total assets, financing & investment and deposits reached 5.1 percent and 4.2 percent and 5.2 percent, respectively, at end June 2009. The deposit base of Islamic banks reached Rs. 238 billion at end-June 2009. (Source: Business Recorder, September 09, 2009). Lately, the Vatican said banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. (Source: Osservatore, March 04, 2009).

Islamic financial industry has achieved financial depth since its re-inception in Pakistan since the late 90s and especially in last 5 years. Takaful (alternative for life and general insurance), Sukuks (alternative of bonds/TFCs/T-Bills, Assets Backed Securitization etc) and Islamic Mutual Funds (alternative for conventional money market, balanced and capital market funds) have been established and are growing appreciably.

Islamic banking does not permit transactions in most conventional derivatives. Futures trading in stock and commodity markets, currency options, currency swaps, swaptions,

short selling and other complex and speculative derivatives are not allowed in Islamic economic principles. The kind of Assets Backed Securitization that only assigns the receivables and not the underlying assets is also not permissible.

However, Salam (payment spot; delivery deferred) is an alternative of short selling and Istisna (order to manufacture) is an alternative for project financing. Salam is different from short selling as the subject matter in Islamic banking should be usable, saleable and must be present in the market from the day of contract of Salam till the maturity. Furthermore, in Salam, the intention of both parties is to execute the sale and not to offset the values only at maturity.

The tacit effects of being shariah compliant are more profound on organization's culture and organizational behavior. It is an established fact in management research that non-monetary motivators are even more effective than monetary motivators. The motivation level of an employee who will work with the knowledge that his/her company is shariah compliant will be greater than working with the company who is not shariah compliant. The employees of a shariah compliant company do not feel cognitive dissonance and their values do not come in conflict with the way organization functions.

Problem Statement

Islamic stock screening principles require sufficient investment in illiquid assets (at least 20% of total assets) and discourage investment in leverage companies (interest based debt must be less than 40% of total assets). On the surface, it may suggest that Islamic principles hinder investment in liquid and leverage companies who get better ROE in booms. This paper analyzes whether Islamic investment principles are hindrance to building a profitable portfolio.

Introduction

When one buys shares of companies, one becomes owner of each and every asset the company has and liable to pay each and every liability limited to the investment (limited liability). Becoming a shareholder means one is taking part in a going concern and is a joint owner in all operations of the business. In that case, Shariah Advisors have recommended certain screening ratios to be followed to ensure that a line is defined; crossing which a company is rendered non-compliant. Most of these ratios are control ratios i.e. it does not make a company permissible or non-permissible through divine injunctions. But, a framework is agreed upon and is tried to be followed in letter and spirit.

Same is not the case when one is a creditor to a company. In providing credit in Islamic banking, Islamic Bank provides financing for the purchase of asset, after the client has paid the price of the asset, the transaction is over, the relationship is over. In that case, screening ratios are not required to be followed. If a person has taken an interest bearing loan and if someone sells an asset to that person using Islamic mode of financing, it is not wrong provided that transaction itself is Shariah compliant. Same is not the case when one becomes a joint owner of the company by purchasing shares because by doing that, a person is participating in whole of the business with a going concern assumption (unless one decides to divest investment in stock, the stock has no maturity). Islamic banks only provide financing to purchase assets. All financial claims are matched in totality with tangible real assets in an Islamic bank.

KSE and Al-Meezan Investment Management Limited launched its first co-branded Islamic Index (KMI-30) on 1st of Ramadan 1429 HIJRA which tracks thirty most liquid SHAIRAH compliant stocks.

Al Meezan Investments provide its Shariah expertise, guidelines, skills and stocks screening towards the activities with regard to launching and continuation process of the Index. On the contrary, KSE provides maintenance and dissemination support for the index.

Objective of Launch of KMI - 30

KMI-30 index has been launched with the following objectives:

- To provide investors suitable benchmark for returns on Shariah Compliant equity investments.
- To help shariah conscious people choose the profitable stocks which are Shariah Compliant.
- To provide a relevant benchmark to Islamic equity funds for comparing their performance.

Research Methodology

This paper is an analytical research. It uses the economic, finance and portfolio theory to analyze whether Islamic investment principles in stocks act as hindrance in building an effective and profitable portfolio. Research is qualitative in nature and it analyzes the principles of investment in the light of established deductive knowledge in Economics, Finance and Portfolio Theory. The paper uses the economic models at appropriate places to support analysis. After this study, subsequent research can also take the empirical data to judge the performance of Islamic and Conventional mutual funds.

Literature Review

El-Fakhani & Hassan (2005) affirmed that the establishment of a credible equity benchmarks by Dow Jones Islamic Market Index (DJMI) and FTSE Global Market Index Series, followed by the Malaysian Kuala Lumpur Shariah Index, has been a turning point for the industry, giving both Islamic and Conventional investors a benchmark to use for comparison.

In a study conducted in Malaysia, Abdullah & et al (2007) concluded that Islamic funds performed better than the conventional funds during bearish economic trends while, conventional funds showed better performance than Islamic funds during bullish

conditions. Forte & Miglietta (2007) analyzed the underlying principles of socially responsible investments and Islamic funds as investment classes, and tried to determine whether Islamic mutual funds, as faith-based investments, can be included into the category of socially responsible mutual funds.

El-Fakhani & Hassan (2005) assessing the performance of Islamic mutual funds, examined whether there exist any significant reward or penalty for investing in them. Moreover, to verify whether the application of the Islamic investment guidelines in asset allocation and portfolio selection has had downside effect on investors' wealth in terms of risk-adjusted returns relative to the market benchmark. The results were somewhat consistent across the different used measures and benchmarks. Their study concluded:

- The emerging markets fund category shows the best performance among all sampled eight Islamic mutual funds categories.
- The Asian fund category shows the worst performance.
- The American and the emerging market-South Africa fund categories follow respectively the emerging markets category.

Therefore, the main conclusion of that study was that the behavior of Islamic mutual funds did not differ from that of other conventional funds, with some Sharia compliant mutual funds over-performing their benchmarks and others under-performing them.

How to Become a KMI – 30 Company?

To become a KMI – 30 Company, a listed company has to meet two sets of criteria

1. Shariah Compliance criteria.
2. Criteria for inclusion in index i.e. reflective and representative of market.

In the second criteria, the company is selected in the index just like the companies are selected in other indexes throughout the world. Free Float and smallest Impact Cost are

two major parameters used throughout the world for construction of an index. Discussing them is not relevant to the scope of this paper. However, the criteria for Shariah Compliance would be discussed in detail.

Screening Criteria # 1: Business of the Investee Company

The business of the investee company should be Halal. Accordingly, investment in shares of conventional banks, insurance companies, leasing companies, Mudarabah companies, companies dealing in alcohol etc are not permissible.

Screening Criteria # 2: Market price/Share > Net Liquid Assets/Share

$$\text{Net Liquid Assets / Share} = \frac{\text{T.A} - \text{F.A} - \text{Inventory} - \text{CL} - \text{LTL}}{\text{No. of shares outstanding}}$$

Market price of the share must be greater than the net liquid assets per share. It implies that the company should invest its excess liquid funds in its operations i.e. buy the assets for which the company acquired funds from the general public. This will decrease the ratio of net liquid assets per share. Similarly, effective operational performance will increase profitability of the company and this will be reflected in higher ROE, ROI, ROCE, and EPS etc. This will push up the demand for the company's shares and the market price of that company will eventually increase enabling the company to meet this ratio.

Screening Criteria # 3: Illiquid Assets/Total Assets > 0.20 or 20%

$$\text{Illiquid Assets} = \text{TA} - \text{Liquid Assets (Cash, Cash equivalents, A/R, Advances, B/As etc.)}$$

Illiquid Assets are tangible assets that are not liquid. Examples include plant, machinery, inventory, building, furniture, fixtures etc. It implies that the company should invest the funds it generates from the public to invest in the tangible assets. An increase in the number of tangible assets gives the signal to the public that the company is or is planning to expand its operations and hence this sentiment can attract investors and push up the market price of the company's shares. Furthermore, this will increase the depreciation

expense of the company and hence it will decrease the corporate taxes the company needs to pay to the government.

Screening Criteria # 4: Non-Compliant Income < 5% of Gross Revenue

Non Compliant Income includes interest; income from gambling, conventional interest based derivatives, structured products and other such instruments, income from nightclubs, prostitution, casinos, tobacco, alcohol, drugs, dividend income from above mentioned businesses etc. However, Capital Gain on scrips of such businesses need not be purified.

If investments from the non-compliant businesses will be divested, it will decrease the income ratio of non-compliant income to total income. The qualitative effects of such disinvestment will be the improved image of the company in the eyes of all stakeholders especially the shareholders, creditors and the customers.

Screening Criteria # 5: Non-Shariah Compliant Investments < 33% of Total Assets

Non-Shariah Compliant Investments include investments in money market funds, money market instruments, bonds, PIBs, FIBs, CoIs, CoDs, TFCs, DSCs, conventional speculative derivatives and structured products etc.

If investments from the non-compliant businesses will be divested, it will decrease the ratio of non-compliant investments to total assets. The qualitative effects of such disinvestment will be the improved image of the company in the eyes of all stakeholders especially the shareholders, creditors and the customers.

Screening Criteria # 6: Interest Bearing Debt < 40% of Total Assets

Interest Bearing Debt includes Bonds, TFCs, Conventional Bank Loans, Finance Lease, and Preference Shares etc.

Debt financing is a double-edge sword. Leveraged companies can magnify their returns in booms, but in slumps, they lose the edge and can even go bankrupt and make both their shareholders and creditors suffer. Debt financing results in a zero-sum game in

which at least one stakeholder i.e. shareholders or creditors suffer. Equity financing ensures normal returns in booms and survival in slumps. Therefore, the company will not be squeezed of liquidity as interest expense as an ‘autonomous expense’ will not feature as a significant portion of total operating expenses.

A simplified economic model will highlight the point that equity financing is less risky and better prone to give profitable results in boom and also in recession. Keeping in view Efficient Market Hypothesis, profitability is perfectly reflected in market prices.

Non-Leverage Company			
Assets	Rs. (in millions)	L + O.E	Rs. (in millions)
F.A	60	Debt	0
C.A	40	Equity	100
<i>Total Assets</i>	100	<i>Total L + O.E</i>	100

Case 1: Economic Boom		Case 2: Economic Recession	
Income Statement (Non-Leverage Company)		Income Statement (Non-Leverage Company)	
	Rs in millions		Rs in millions
Net Sales	100	Net Sales	60
Cost of Goods Sold (70% of sales)	70	Cost of Goods Sold (70% of sales)	42
Gross Profit	30	Gross Profit	18
Operating Expenses	10	Operating Expenses	10
PBIT	25	PBIT	8
Interest Expense (12%)	0	Interest Expense (12%)	0
PBT	25	PBT	8
Tax Expense (20%)	5	Tax Expense (20%)	1.6
Net Income	20	Net Income	6.4
ROE	20%	ROE	6.4%

A simplified economic model will highlight the point that debt financing can provide better profitability ratios in boom but it is more risky and less prone to give profitable

results in recession. Keeping in view Efficient Market Hypothesis, profitability is perfectly reflected in market prices.

Leveraged Company			
Assets	Rs. (in millions)	L + O.E	Rs. (in millions)
F.A	60	Debt	60
C.A	40	Equity	40
<i>Total Assets</i>	100	<i>Total L + O.E</i>	100

Case 1: Economic Boom Income Statement (Leveraged Company)		Case 2: Economic Recession Income Statement (Leveraged Company)	
	Rs in millions		Rs in millions
Net Sales	100	Net Sales	60
Cost of Goods Sold (70% of sales)	70	Cost of Goods Sold (70% of sales)	42
Gross Profit	30	Gross Profit	18
Operating Expenses	10	Operating Expenses	10
PBIT	25	PBIT	8
Interest Expense (12%)	7.2	Interest Expense (12%)	7.2
PBT	17.8	PBT	0.8
Tax Expense (20%)	3.56	Tax Expense (20%)	0.16
Net Income	14.24	Net Income	0.64
ROE	35.6%	ROE	1.6%

The model proves that in economic booms, leveraged companies are more profitable than non-leveraged companies, but in recessions, leveraged companies are less profitable and hence riskier than non-leveraged companies. Hence, leveraged companies are depending on the assumption that the economic boom will last indefinitely.

Modigliani & Miller (1963) argued that value of a levered firm is greater than the value of an unlevered firm. The difference in value comes from the tax benefit accruing to a

levered firm. But, they ignored the bankruptcy costs and the case where even if a company is solvent, the economy may go through a recession.

Furthermore, if this tax benefit is provided to an unleveled firm by making dividends to be tax deductible; then, value of a levered firm may cease to have any extra value greater than an unlevered firm.

Conclusion

This study tried to address the skepticism that may develop about the Islamic investment principles being prone to avoid picking stocks in companies which have enough liquidity and/or which have highly leveraged capital structures. The analysis and economic models presented in the study showed that high liquidity and/or high leverage can have alternative meanings and do not necessarily mean beneficial to the investee company or to its investors. The literature review presented showed that Islamic Mutual Funds have performed competitively and have not lagged behind their conventional counterparts.

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